ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author:	Campbell	Analyst:	Marion Mann DeJong	Bill Number:	AB 85X
Related Bills:	See Legislative History	Telephone:	845-6979	Introduced Date:	02/26/2001
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Manufacturers’ Investment Credit/Extend to Oil & Gas Extraction Industries

SUMMARY

This bill would extend the Manufacturers' Investment Credit (MIC) to oil and gas extraction businesses.

PURPOSE OF THE BILL

The purpose of this bill appears to be to encourage investment in property that extracts oil and gas.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would become effective immediately upon enactment and would be operative for taxable years beginning on or after January 1, 2001.

POSITION

Pending.

Summary of Suggested Amendments

Amendments are needed to add tangible personal property used by oil and gas extraction taxpayers to the definition of “qualified property” and to add an activity test for “extracting.” See “Implementation Considerations” below. Department staff is available to assist the author with these amendments.

Technical amendments are provided to reference the specific laws that have amended the MIC. See “Technical Considerations” below.

ANALYSIS

FEDERAL/STATE LAW

Existing state and federal laws allow a taxpayer to deduct expenses paid or incurred in the ordinary course of a taxpayer’s trade or business. Also, these laws allow a depreciation deduction for the obsolescence or wear and tear of property used in a trade business or held for the production of income.

Board Position:			Department Director	Date
____ S	____ NA	____ NP	Alan Hunter for GHG	03/16/2001
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Existing federal law does not have a credit comparable to the MIC. However, federal law does allow taxpayers an enhanced oil recovery credit that is combined with several other credits to form the general business credit. This credit is 15% of the taxpayer's qualified enhanced oil recovery costs. Enhanced oil recovery costs are defined as amounts paid or incurred for qualifying tangible property that is depreciable or amortizable and an integral part of a qualified enhanced oil recovery project, qualifying tertiary injectant costs, and qualifying intangible drilling and development costs. The credit is allowed on costs connected to a qualified enhanced oil recovery project which involves the application of a tertiary recovery method that is expected to result in a significant increase in the amount of crude oil recovered. A licensed petroleum engineer must certify this project. The credit is phased-out based on the average per barrel wellhead price of domestic crude oil. No phaseout applies for the 2000 credit.

Existing state law allows taxpayers to use various credits against tax such as the enhanced oil recovery credit and the MIC.

The enhanced oil recovery credit is equal to one-third of the taxpayer's allowed federal enhanced oil recovery credit. The state credit applies only to oil recovery projects located within California and may not be claimed if the taxpayer would not qualify for a specified depletion allowance under federal law. Essentially, retailers, certain related parties, and refineries whose output exceeds 50,000 barrels on any day of the year would be excluded. If property qualifies for both this oil credit and any other credit, such as the MIC, the taxpayer would not be able to claim both credits on the same property.

The MIC allows qualified taxpayers a credit equal to 6% of the amount paid or incurred after January 1, 1994, for qualified property that is placed in service in California.

For purposes of the MIC, a qualified taxpayer is any taxpayer engaged in manufacturing activities described in specified codes listed in the Standard Industrial Classification (SIC) Manual, 1987 edition. Qualified property is any of the following:

1) Tangible personal property that is defined in Section 1245(a) of the Internal Revenue Code (IRC) and used primarily for:

- manufacturing, processing, refining, fabricating, or recycling of property;
- research and development;
- the maintenance, repair, measurement, or testing of otherwise qualified property; or
- pollution control that meets or exceeds state or local standards.

2) The value of any capitalized labor costs directly allocable to the construction or modification of the property listed in #1 above or for special purpose buildings and foundations listed in #3 below.

3) For certain taxpayers engaged in specified SIC Code activities, special purpose buildings and foundations.

For taxpayers engaged in computer programming and computer software related activities, qualified property includes computers and computer peripheral equipment used primarily for the development and manufacture of prepackaged software, and the value of any capitalized labor costs directly allocable to such property.

The MIC explicitly excludes certain types of property from the definition of qualified property, such as furniture, inventory, and equipment used in an extraction process.

THIS BILL

This bill would add taxpayers engaged in oil and gas extraction activities to the definition of "qualified taxpayer" under the MIC provisions. The oil and gas extraction activities are described in SIC Codes 1311 to 1389 as establishments primarily engaged in:

- producing crude petroleum and natural gas;
- extracting oil from oil sands and oil shale;
- producing natural gasoline and cycle condensate; and
- producing gas and hydrocarbon liquids from coal at the mine site.

The types of activities included are exploration; drilling; oil and gas well operation and maintenance; natural gasoline and cycle plant operation; and gasification, liquefaction, and pyrolysis of coal at the mine site.

This bill modifies the list of property excluded from the definition of "qualified property" so that equipment used for the extraction processes described in SIC Codes 1311 to 1389 would now qualify for the MIC. However, this bill did not specifically add property used by oil and gas extraction taxpayers to the definition of "qualified property" or modify the activity test within that definition.

This bill also would make minor technical changes to delete obsolete language referencing the low-emission vehicle credit and change "which" to "that" in various places.

IMPLEMENTATION CONSIDERATIONS

As currently drafted, this bill would not affirmatively provide a credit for equipment used in oil and gas extraction activities. To achieve the author's goal, the definition of "qualified property" should be amended to add those activities engaged in by oil and gas extraction taxpayers to the list of qualified activities, as well as add the SIC Code activities engaged in by those taxpayers under the qualified property definitions. In addition, an "extraction activity test" should be provided to clarify how the property must be used to qualify for the credit. Department staff is available to assist the author with these amendments.

TECHNICAL CONSIDERATIONS

Amendments 1 through 4 would reference the specific laws that amended the MIC.

LEGISLATIVE HISTORY

AB 703, Setencich (1995/1996) would have extended the MIC to taxpayers involved in oil and gas extraction and created a state enhanced oil recovery credit. The MIC provisions were amended out of AB 703.

AB 94, Cardoza (1997/1998) would have extended the MIC to agricultural commodities and oil and gas extraction activities. The MIC provisions were amended out of AB 94.

AB 1275, Campbell (2001/2002) is identical to this bill.

OTHER STATES' INFORMATION

Review of *Illinois*, *Massachusetts, Michigan,* and *New York* tax laws found no comparable tax credit for investments in property used to extract oil and gas like that proposed by this bill. The laws of these states were reviewed because they have credits comparable to the MIC.

FISCAL IMPACT

If the implementation consideration addressed in this analysis is resolved, the department's costs are expected to be minor.

ECONOMIC IMPACT

Revenue Estimate:

Extending the MIC to oil and gas extraction industries would result in the following revenue losses:

Revenue Impact of ABX85 For Taxable Years Beginning On Or After January 1, 2001 Assumed Enactment After June 30, 2001 (In Millions)		
2001-02	2002-03	2003-04
-$24	-$29	-$30

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion:

This estimate is based on data from an U.S. Census Bureau survey of capital expenditures by relevant industries for 1998 and microsimulation models of California tax returns for tax years 1997 and 1998. These numbers were grown to approximate 2001 and beyond. The credit use rates taken from the models were then applied to derive the aggregate credit use. The fiscal year cash flow patterns are based on the department's analysis of how manufacturers adjusted their tax payments to reflect the reduction in liability from the current law MIC.

This estimate does not include losses resulting from qualified taxpayers as defined under current law that might receive additional credit for activities that would qualify under the changes made by this bill. Such losses cannot be quantified since the data and information needed are not available.

ARGUMENTS/POLICY CONCERNS

This bill would extend the MIC to the new class of added taxpayers in situations where binding contracts to engage in the qualified activities already exist and would not be limited to benefit only future business decisions. Under this bill, any costs paid under the terms of a contract entered into after January 1, 1994, but prior to taxable years beginning on or after January 1, 2001, would qualify for the credit.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 85X
As Introduced February 26, 2001

AMENDMENT 1

On page 13, modify line 8 as follows:

(j) The amendments made by ~~the act adding this subdivision~~ Chapter 954 of the Statutes of 1996

AMENDMENT 2

On page 13, modify line 11 as follows:

(k) The amendments made by ~~the act adding this subdivision~~ Chapter 323 of the Statutes of 1998

AMENDMENT 3

On page 24, modify line 31 as follows:

(j) The amendments made by ~~the act adding this subdivision~~ Chapter 954 of the Statutes of 1996

AMENDMENT 4

On page 24, modify line 34 as follows:

(k) The amendments made by ~~the act adding this subdivision~~ Chapter 323 of the Statutes of 1998